



# Senator Ted W. Lieu

## 28<sup>th</sup> Senate District

# SB 209 (Lieu & Gorell)

## Stop the Retroactive Tax

### Fact Sheet

#### Purpose:

To stop retroactive taxes, preserve the rule of law, and implement *Cutler v. Franchise Tax Board*, relating to the “qualified small business stock” incentive, in a manner that:

- 1) Does not retroactively collect 5 years of taxes from 2,500 small business entrepreneurs;
- 2) Holds the General Fund harmless; and
- 3) Prospectively preserves the incentive to invest in California start-up ventures to the maximum degree possible.

#### Background:

As a result of a recent appellate court ruling in 2012, *Cutler vs. FTB*, (208 Cal. App. 4th 1247 (2012)), the Franchise Tax Board (FTB) is retroactively taxing people that legally used the Qualified Small Business Stock (QSBS) tax incentive allotted to entrepreneur/investors in California start-up small businesses. The *Cutler* court found certain provisions of the QSBS unconstitutional. Thousands of taxpayers – investors and entrepreneurs – who sold qualified small business stock as far back as January 1, 2008 will be receiving *retroactive* personal income tax assessments averaging \$60,000 each, with some even as high as \$500,000, plus penalties and interest.

However, the US Supreme Court in *McKesson Corp. v. Florida Alcohol & Tobacco Div*, 496 U.S. 18 (1990) has authorized non-retroactive remedies to correct tax provisions found to be unconstitutional. The FTB took the retroactive approach based on their view that they lacked the statutory authority to stop the retroactive actions, and only the legislature could do so. This bill implements the non-retroactive approach authorized by the US Supreme Court.

#### Deficiency in Current Law:

Current law, as interpreted by the FTB, has many deficiencies:

**Retroactive changes in tax law which trigger retroactive tax assessments are inherently offensive and unfair.**

The taxpayers the FTB seeks to assess followed the QSBS law exactly as it was written by the Legislature and implemented by the FTB. They also risked their capital and poured their efforts into creating start-up businesses which are the heart of the California economy. They are entitled to rely on the state’s representations that in exchange for doing so, they would receive a tax benefit. To allow the state to retroactively “move the goalposts” is contrary to California’s ideals of fundamental fairness and would result in the state getting an unfair windfall of close to \$200 million.

**California already got the “Benefit of the Bargain”;**

California created the QSBS incentive to encourage entrepreneurs to invest in start-up companies *in California* not only because these businesses are responsible for virtually all net job growth in California, but also because they develop new technologies and new industries in California that in turn employ thousands more Californians. For the years in question (2008-2012), California got the benefit of what it bargained for in the form of new jobs and wealth creation. For the state to be allowed to keep the jobs and wealth, and “claw back” the tax incentive gives the state an unfair and undeserved windfall.

**Issuing retroactive tax assessments when a legal defect is found with a tax credit provision will undermine confidence in ALL of California tax incentives.**

If taxpayers know that the state may send four years of retroactive tax assessments anytime a tax incentive provision is challenged, confidence in California’s economic development program is seriously



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undermined. For example, most recent FTB data shows that taxpayers claim annually almost \$2 *billion* in Research & Development tax credits for R&D performed *in California*. Will technology firms risk an \$8 billion retroactive tax assessment if a court were to strike down a portion of the statute, or would they simply perform their R&D in states that offer a similar benefit with no risk of retroactivity?

**The FTB position would fundamentally harm the economy and job creation because virtually all net job growth in California is created by start-up firms.**

According to the most recent studies, virtually all of California's net job growth is attributable to start-up ventures (less than 1 year old). By contrast, with the exception of one year in the last decade, firms older than one year showed a net *loss* of California jobs. Unless SB 209 passes, the loss of the QSBS exclusion/rollover would cause fundamental damage to California's efforts to emerge from recession and put Californians back to work.

### **This Bill:**

1. Clarifies that the QSBS incentive remains for 2008-2012, retaining the requirement "at issuance" that the stock be in a small business that has 80% of its compensation paid to Californians.
2. Holds the General Fund harmless by not restarting the QSBS incentive in years 2013-2015;
3. Commences the QSBS incentive again for 2016 forward;
4. Ensures retroactive tax assessments would *not* be sent.

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